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INTEREST AND PROFITS.

Adam Smith and his contemporaries analyzed the price of commodities into three component parts—wages, profits and rent. Neither of the last two terms was used exactly as we use them to-day. Rent, in its modern sense, is the payment for land as distinct from improvement ; profit, in its modern sense, is the return for managing ability as distinct from capital. But, to Smith's mind, rent was the payment for the land and the permanent improvements which it carried with it ; profits, the return for the managing ability of the employer and the capital which he employed. Both rent and profits, as Smith understood them, included a large measure of what modern writers would call interest. Rent was substantially a return on long-time investments when made with foresight ; profits, a return on short-time investments, when managed with ability.

Among the many changes made by Ricardo in the form of Economic Science, none was more important or characteristic than his recognition* of interest as distinct from rent.

* Even more clear in fact than in expression.

Ricardo was a banker, familiar with the conception of market rates of interest, and the effect of those rates on the profit or loss in financial transactions. He saw that the real profit of an enterprise was not the total return above current expenses, but the excess of such return above current rates of interest on the capital employed. The real ground-rent of a piece of improved land was not the total amount paid for such land by the occupier, but the excess of this amount above the interest on the capital invested.

Had Ricardo and his followers contented themselves with pointing out a new component in the price of commodities there would have been an unmixed gain in clearness of analysis. But they did not stop here. They treated interest as representing the capitalists' just share in the distribution of wealth; and they supported this idea of justice by arguments so inconsistent or superficial as to furnish every opportunity for the attacks of the socialists. They have represented interest as a reward of abstinence; in the face of the fact that those whose interest accounts are largest have generally had to practice the least abstinence. They have represented it as due to the inherent productivity of capital, in spite of the fact that large accumulations of capital present opportunities for waste and loss quite as conspicuous as those for efficiency and profit. The masterly analysis of Böhm-Bawerk has submitted these theories to a criticism at once so searching and so just that it is unnecessary to do more than refer the reader to what he has written.

And yet, with all respect to the eminent author just named, we may be pardoned for saying that his method appears in some respects unsatisfactory. He often seems to treat simultaneously two sets of enquiries which are best handled separately. The causes which have produced the *system* of interest are radically different from those which determine the *rate* of interest. The tendency of political economists with few exceptions has been to confuse the two, and to try to take one step where two are absolutely necessary. The system

of interest is an institution recognized by society because of its advantages to society. The rate of interest is the result of a set of estimates and valuations on the part of individuals living under the institution and accustomed to the system. The excellence or permanence of the institution does not necessarily depend on the correctness of the estimates of individuals.

Unless this distinction is borne in mind every effort to give precision to our ideas of interest is liable to make the confusion worse. For instance: we are told that interest is justified by the productivity of capital. Now in a rough way, this has a large element of truth. If capital is saved and utilized, society gets more goods for its labor; and it is compelled to offer incentives, of which the system of interest is a most powerful one, to cause capital to be thus saved and utilized. But the modern economist is more precise. He tells us that interest cannot be offered merely because the output is increased; it may be that the price will fall so fast that the larger output will command a smaller aggregate return, and then no interest can be paid. To enable a man to offer interest, he says, the new investment must increase profits as well as products. This may be true economically; it is untrue sociologically. It may be that a man cannot afford to do it; it remains certain that he frequently does it. A great deal of interest is offered and paid on investments which do not increase profits. Such payments are not collected from the consumer; they do not go to increase the share of capitalists as a class; but they are none the less an important part of the actual interest transactions.

It is the aim of this paper to show that the justification of interest, as an institution, is not to be sought either in the interest productivity of capital, or in the difference of value between present and future goods; but in the fact that it furnishes a means of natural selection of employers whereby the productive forces of the community are better utilized than by any other method hitherto devised. This view of

interest differs from those which have been previously held in the same way that the theory of civil liberty of the nineteenth century differs from that of the eighteenth. We no longer seek to deduce liberty from the nature of man, nor do we deny that liberty involves frequent and flagrant errors; but we have found that the modern system of civil liberty is the best available means of combining progress with conservatism, and that its very errors form a means of eliminating the bad and may thus indirectly serve as a gain to society. Let us in like manner cease to deduce interest from the nature of capital; let us cease to insist on a connection between the institution of interest and the correctness of judgment of those who offer it; let us look at its history as a means of combining industrial progress with industrial conservatism; as a means of elimination of the industrially unfit from any position of leadership which they may have attained; as a system which makes the wrong judgments as well as the right judgments of individuals ultimately serve as a means to the advance of society.

We can without much difficulty trace three stages in the development of modern industrial law; the first, where a man was allowed property as a stimulus to labor and save; the second, where he was allowed profits as a stimulus to exercise skill and foresight in management; and the third, historically almost coincident with the second, where he was allowed to offer interest to induce others to give him the means of exercising his skill and foresight over the widest range.

Communism had tended to prevent the production and accumulation of resources without which no race can advance to the higher stages of industrial civilization. Private property, even in its ruder forms, did better. It afforded a stimulus to production; while the institution of the family enabled food consumption to be kept below the limit of food production, and allowed the accumulation of a surplus in individual hands.

The next step in industrial progress was to make this individual surplus serve as a means of social progress. This was accomplished by the development of free competition. By encouraging a man who had accumulated or inherited resources to use them in a far-sighted manner, society gained the fullest advantage from those resources. Even if such an individual made a large profit the gain which accrued to him as an individual was but a small fraction of that which accrued to society as a whole. If society would have the gain, it was forced to allow the profit. Any departure from traditional methods involved large risks to him who first attempted it; and society could not expect the capitalist to take large risks without the chance of considerable profits. The man whose land improvements had turned out well was allowed by our system of land tenure a monopoly of the location which he had developed. The man whose methods had turned out well was allowed by our system of patent right a monopoly of the process he had exploited. The profit in either case accrued to him as a capitalist. The history of land tenure makes this point extremely clear. In the passage from the twelfth to the sixteenth century in England, we can trace the change from a feudal rent paid to a political authority for *security*, to an economic rent paid to a capitalist for *permanent improvements*. The *amount* of rent in the particular case might not, and did not always, correspond to the cost of the improvements; but the system of industrial rent was developed for the sake of those improvements, and rent in the aggregate may fairly be regarded as the price paid for the improvements as a whole.

We have thus far traced the effect of private property as a stimulus for the saving of capital, and of profits or rent as a stimulus for its utilization. But we have not yet touched upon the causes which led to the recognition of interest. If the view of this paper is correct it was developed not as a stimulus for the saving or the investment of capital, so much as for promoting the natural selection of the fittest employers

and the best processes. And this system of natural selection constitutes the third and last step in the development of the modern industrial order.

In any large investment there are two classes of interests, represented roughly, by the stockholders and the bondholders of a railroad. The former class wants *control;* it is willing to take risks and pay for them for the sake of contingent profits. The latter class wants security and fixity of returns ; for the sake of this it is willing to delegate control and to abandon possible chances of large gain. The modern system of interest is nothing more than the recognition of these two classes of investors and their mutual relations. Interest results from a contract between two capitalists uniting in a common enterprise. It is a sum paid by one investor to another investor—out of capital, if necessity shall require. If the borrower has not capital enough to cover such contingent necessity, the contract is one of insurance or of fraud—more commonly the latter. This is exemplified in those cases where railroad stock is nearly all water, or where a merchant uses his credit in operations whose risk is beyond the amount of his own personal possessions.

It is a further essential of interest, as a system, that lender and borrower shall invest their resources. Where interest is offered in connection with other objects than investment, as in the case of a pawnbroker's shop, the transaction does not command public approval and is stigmatized as usury. It was because mediæval interest transactions were for purposes other than investment that they were discountenanced by public opinion and prohibited by canon law. When there was a demand for capital for investment, it did not take long for the canonists to invent theories of *lucrum cessans* which made their traditional prohibitions nearly void.

If this view is correct interest from the standpoint of the borrower is the price paid for the control of industry. Capital gives its possessor the right to direct the productive forces of society and take the speculative risks in so doing.

When some of those who unite in an investment are anxious to do this, and others are not, the former stand ready to offer the latter a price for such rights of control and speculation. Such a price, let it be repeated, cannot be offered by the man without capital to the capitalist. A man must have some capital to be able to furnish the guarantee of repayment. It is paid by one capitalist for the sake of controlling another man's capital. It enables the enterprising men to get the direction of a larger amount of productive power than would otherwise be possible. If their methods are good it contributes to the more speedy adoption of these methods; if they are bad it contributes to the more speedy elimination from the ranks of the capitalists of the men who make such mistakes. The institution of interest is like that of joint-stock companies in giving men control of larger capital than they themselves own; while, unlike a joint-stock company, it automatically eliminates men from control when they make serious mistakes. At any rate that is theoretically true. In practice it too often happens that the money is borrowed by men who cannot really furnish the security and are handling other people's capital with little risk to themselves. In such cases the institution of interest is extremely bad. The bondholder in a railroad whose stock is heavily watered, often takes the real risks, with none of the rights of control possessed by a stockholder. The board of directors under such circumstances has every temptation to misuse its powers; and when the directors have made all the money possible at the expense of those who have trusted them, they withdraw with their profits to repeat the same operations in another field. Unless law and public sentiment are in some respects better than we find them in America to-day, the system of interest may tend to the aggrandizement rather than the elimination of those who waste society's capital.

Interest, from the standpoint of the man who offers it, is a payment for control—for the right to speculate, if we can dissociate this term from the odium which attaches to it—

countenanced by society as a means of getting its capital progressively managed. But what of the man who receives interest? Interest from his standpoint is commuted profits, or even commuted rent—using these words as Adam Smith did, in their concrete commercial sense, rather than their abstract economic one. Let me repeat the phrase, for it represents a conception rather unfamiliar to modern economics. Interest in one of its most important phases is *commuted rent.* A group of investors develop a farm or mine, build a factory or a railroad. They expect the average value of the annual output to be in excess of its current cost. This excess is rent or profits in the sense used by Adam Smith. The two terms are not clearly distinguishable, but rent is in general the permanent return due to foresight in an investment, and profit the more temporary return due to skill in its management. Now some of the investors prefer to take the chances of what that rent or profit will be; others prefer to commute those chances for a fixed annual payment. The latter receive interest; the former pay it. Society wishes to encourage both classes of investors and therefore allows such payments. It not merely gives the investor control of industries but allows him to dispose of such control, with its attendant chances, for the sake of a commuted return of fixed amount.

What is it that fixes the amount of this return and determines the rate at which profits shall be commuted? It was in answering this question that Ricardo introduced his chief modifications of Adam Smith's views, and developed an important truth to a further limit than the facts perhaps warranted.

Ricardo saw the fallacy in Smith's assumption of a "current rate of rent" as an element in the price of products. He saw that ground-rent was in large measure a consequence rather than a cause of price; that the land bears rent because of the price of wheat, instead of wheat bearing a price because of the rent of land. He separated what Smith had called rent into two parts, rent proper, and interest; one of which

was a consequence of price, the other a cause of it. The same analysis which Ricardo applied to rent has been applied by modern economists to profits also. The current economic thought of the day regards cost as composed of two elements, wages and interest. The price of a product, it is said, must cover these two things; in cases when it more than covers them, it leaves a surplus in the form of rent or profits. Neither rent nor profit represents a current rate of payment for anything but a *differential* gain.

This is true enough of rent and profit; but we doubt whether the distinction between these elements and the element of interest is anywhere nearly so sharp as many economists are disposed to make it. Why, it may be asked, do we regard interest as a necessary part of the cost of production while rent or profit is not? Partly because capital represents stored-up labor in distinction from natural resources or abilities, so that the use of capital in production may be regarded as labor-cost indirectly applied; partly because capital is competitive and can find profitable employment in any one of a variety of lines, while land or natural abilities have a monopoly under some circumstances, and no use whatever under others. The last distinction is much the more important one; indeed, under current theories of value, the only one of any special account. Under this view, interest differs from profits because a man with capital can get a return in any one of an indefinite number of lines, while a man with land or brains must use them for what they are specially adapted. We may conceive the orthodox economist to say, "Grant, if you please, that interest is commuted rent; nevertheless, the amount of rent is fixed by the circumstances of the particular industry or locality, while the rate of commutation is fixed by conditions affecting all industries and all localities. Interest is fixed by the demand and supply of loans. The demand is doubtless due to expected profits or expected rent in particular lines; but the supply is limited only by general conditions, which establish

a general *rate* of interest on good security, and leave the special demands of each trade to fix the *quantity* of capital directed toward one line or another rather than the rate of interest in that line.

No one would deny that such a state of things as this might exist; but whether it does actually exist is open to question. Loanable capital is not competitive to anything like the extent which this reasoning assumes. One man invests in England, another in America; one invests in farms, another in factories, another in railroads. A man can transfer his investment from one line to another more easily than his abilities; so far there is good ground for the distinction between interests and profits. But the difference is one of degree rather than of kind. Economic interest is an abstraction no less than the economic rent which is based upon it. There are different rates of interest on equal security in the same market. If everybody had equal intelligence in investment it would not be so. But this assumption is far from being realized. There are differences of intelligence in investment, just as there are differences of intelligence in business management. We have no more right to ignore the former in our theory of interest than to ignore the latter in our theory of profits. Capital as such has no more productivity than land as such or brains as such. Difference of valuation of present and future goods may establish a theoretical minimum of interest; but not through the agency of a single general market for loans.

The capitalists advance wages; they take their chances of the price of the product. The excess of price above cost is the amount received by the capitalists in the form of profits or rent. Rent and profits are paid by society to the capitalists for their investments or their abilities. Interest is paid by one group of capitalists to another. It is a commuted rent or profit paid for the control of industry by those who are willing to take the chances. As a rule it will increase or diminish as rent and profits increase or diminish—but not

necessarily so. It will absorb a large proportion of profits where many people want the control of capital and few wish to commute; while conversely it will absorb a small proportion of profits where there are few who want control and many who wish to commute.

The adjustment which the interest rate produces between demand and supply of capital does not operate solely or perhaps chiefly by attracting outside capital into the business. Outside capital is attracted by profits rather than by interest. It seems to go where there are large profits, rather than where there is large real interest.* But a change in the interest rate may powerfully affect the proportion of those in any business who do and those who do not commute the profits. With any given amount of capital the lower the rate of interest the more valuable is the control of industry, and vice versa. The adjustment between the numbers of active and passive participants in any line of industry is a most powerful means of equalizing the demand and supply of loans at any given rate of interest.

If these views be correct interest is essentially a price paid by one group of capitalists to another, for the control of industry on a large scale. The system is justified by its effect in the natural selection of employers and methods rather than by any contribution made by the individual receiver of interest to the good of society. The rate of interest does not depend so directly as has been supposed on a general market for capital, but is the result of commutation of profits in particular lines; the terms of this commutation depending upon the relative numbers of those who desire control and those who are willing to part with such control for the sake of avoiding the risks which it entails.

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* It is often unintelligently diverted into new lines by the offer of large nominal rates where the element of insurance or fraud is dominant.